AIR TRANSPORT ASSOCIATION OF AMERICA, INC.

STATEMENT FOR THE RECORD
BEFORE THE
COMMITTEE ON COMMERCE, SCIENCE & TRANSPORTATION
SUBCOMMITTEE ON AVIATION
UNITED STATES SENATE

HEARING ON AIRLINE FINANCIAL STABILITY
July 13, 2005

The Air Transport Association of America, Inc. (ATA) appreciates the opportunity to comment on the financial health of the U.S. airline industry. Unfortunately, the overall financial picture remains grim because the price of oil continues to surge. Increasing oil and fuel prices have offset the recent modest improvement some carriers have experienced on the revenue front. We would like nothing better than to dwell on what little good news there is, but to do so would be misleading. The truth is, the financial health of the U.S. airline industry remains poor, and the industry still has a long way to go before it can be declared healthy again.

The Current Industry Snapshot

The U.S. airline industry in 2005 remains in critical condition and is poised to add over $6 billion to the $32.3 billion in losses incurred between 2001 and 2004. The current state of the industry is the result of factors and events that have altered industry fundamentals. The fact that industry fundamentals have changed distinguishes this down cycle from all prior cycles.

One fundamental that has changed is that spending on air travel has dropped to 0.7 percent of U.S. GDP from its historical level of between 0.9 and 1.0 percent of GDP. This means that on a proportional basis Americans today are spending considerably less

on flying than in previous years – amounting to roughly $29.5 billion annually. If spending had slipped to just 0.8 percent of GDP, the industry's financial condition would be markedly different.

All airlines have been affected by these fundamental changes, and all airlines have responded in kind by sharply reducing or limiting controllable costs, paring back capital spending, revising long-standing collective bargaining agreements, streamlining operations and improving productivity. While there may be pockets of such costs still to be addressed at some airlines, no one should forget that more than 100,000 employees – one out of six – have lost their jobs since 9/11. There is no question that the airline industry has drastically reduced controllable costs.

Notwithstanding these Herculean efforts, industry profitability remains elusive, and the timing of the industry's return to profitability is unclear. While recently there have been some hoped-for signs of recovery, those signs have been inconsistent and the industry's financial health remains dependent on many factors outside of its control: a strong economy, effective security worldwide, reduced or stable oil prices, and an air traffic control system that will accommodate safely and efficiently the growth demanded by the American public.

Notwithstanding these financial challenges, it should not be overlooked that airline safety has remained rock solid. "Safety first" remains the core industry value. In 2004, the National Transportation Safety Board (NTSB) reported only one fatal accident in over 10 million scheduled departures. In the three years 2002 – 2004, there were just three fatal accidents in 31 million scheduled departures. In those three years, airlines

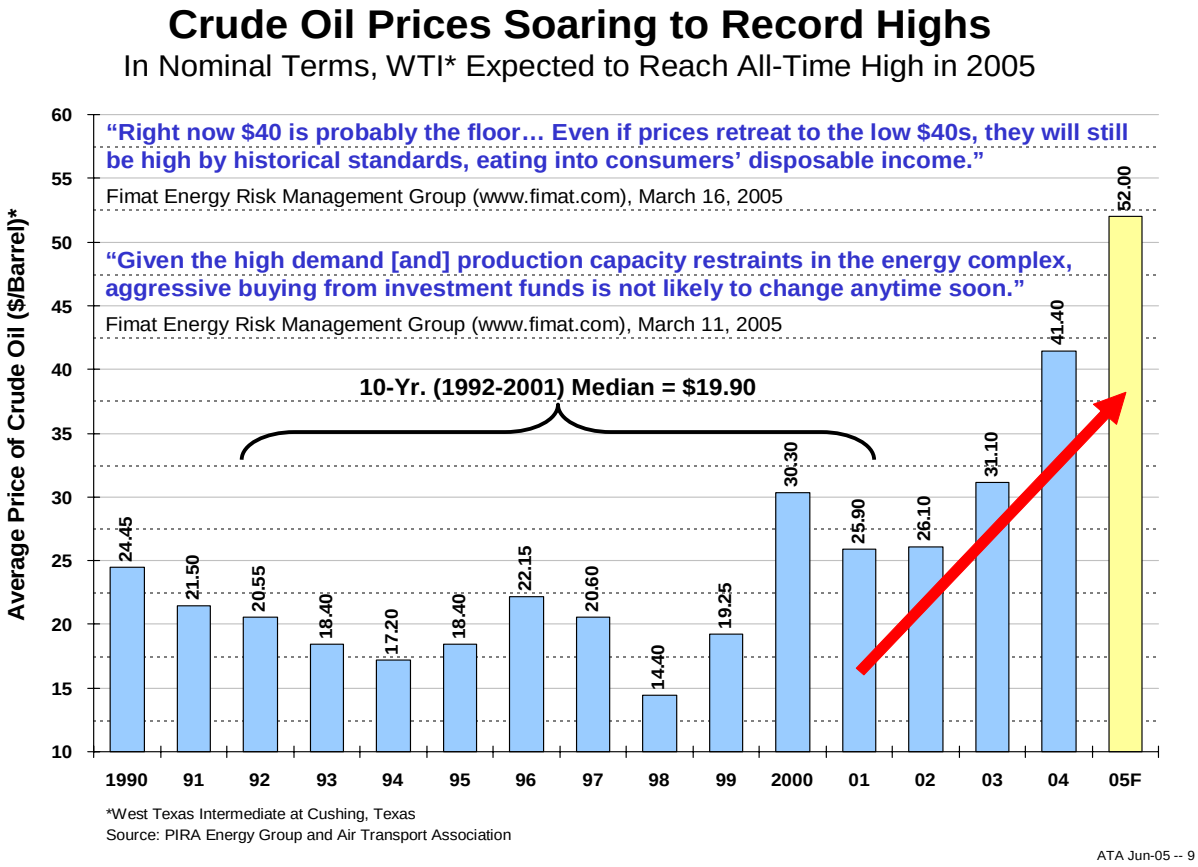
providing Part 121 scheduled operations carried nearly 1.9 billion passengers. Without question, scheduled air service is incredibly safe.

The events and factors that knocked the U.S. airline industry into a condition requiring the equivalent of intensive care are well known and need not be repeated here. However, there are certain factors that warrant further attention because they continue to adversely affect the industry's financial condition. The common thread running through these factors is that they are beyond the direct control of the airlines.

1. The Cost of Fuel Forecloses Financial Recovery

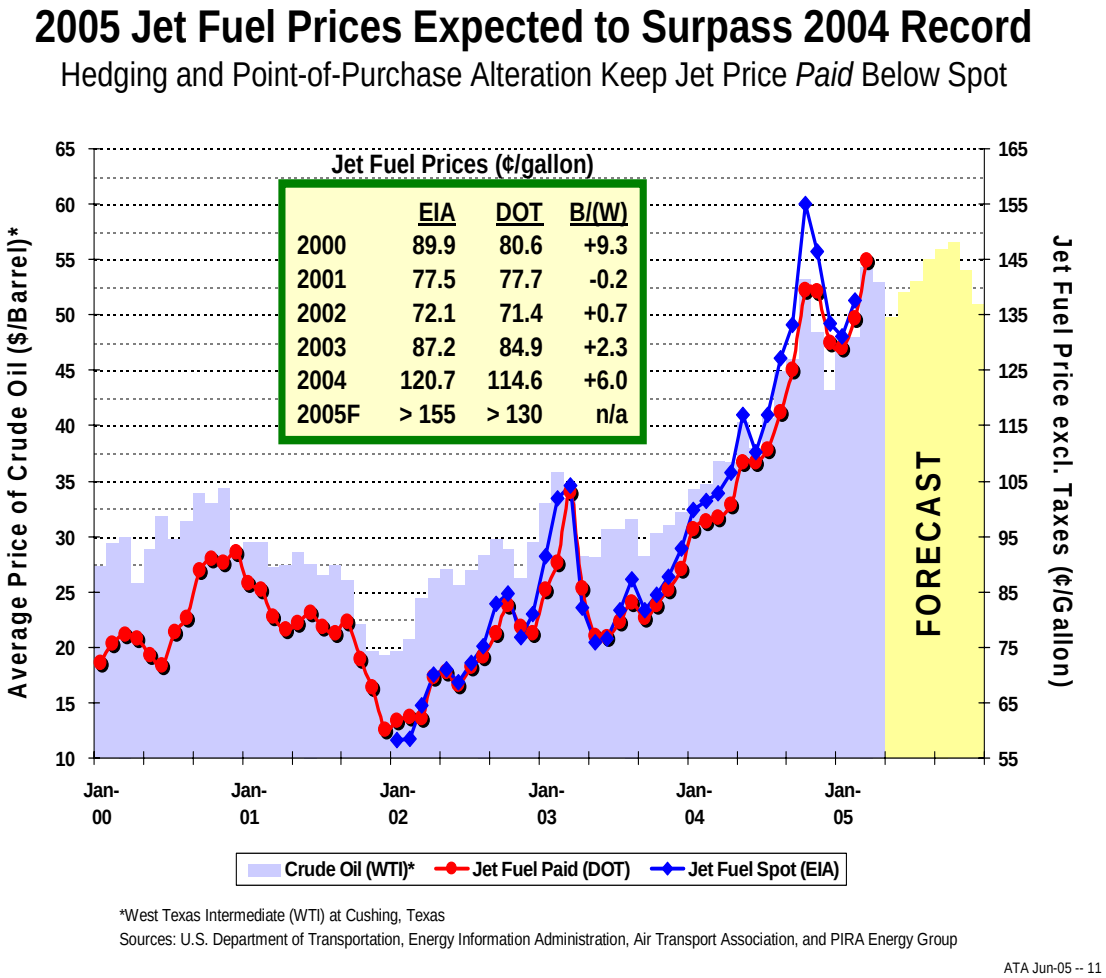
The simple truth is that, but for the high price of fuel, the U.S. airline industry today could earn a small profit. As industry fundamentals go, the price of fuel is the most significant force affecting the industry today. For the ten year period 1992–2001, the median price of crude oil was $19.90. Even in 2001 and 2002 crude oil was relatively stable in the $25-26 range. In 2003, the average price jumped to over $31 a barrel, and in 2004 the average price jumped again to more than $41 a barrel. Today, crude is over $60 per barrel, and the 2005 price is expected to average at least $52 per barrel. In fact, the twelve month rolling forecast currently has crude oil at over $60 per barrel through July 2006.[1] In essence, oil prices have nearly doubled in two years, and when compared to the 1992-2001 median average they have tripled.

[1] Fimat, Energy Overview (July 8, 2005), found at http://research.fimat.com/dominoapps/fimatres.nsf/C5934649E5F8BDB886257038004DFC75/$FILE/tcc1_new.pdf

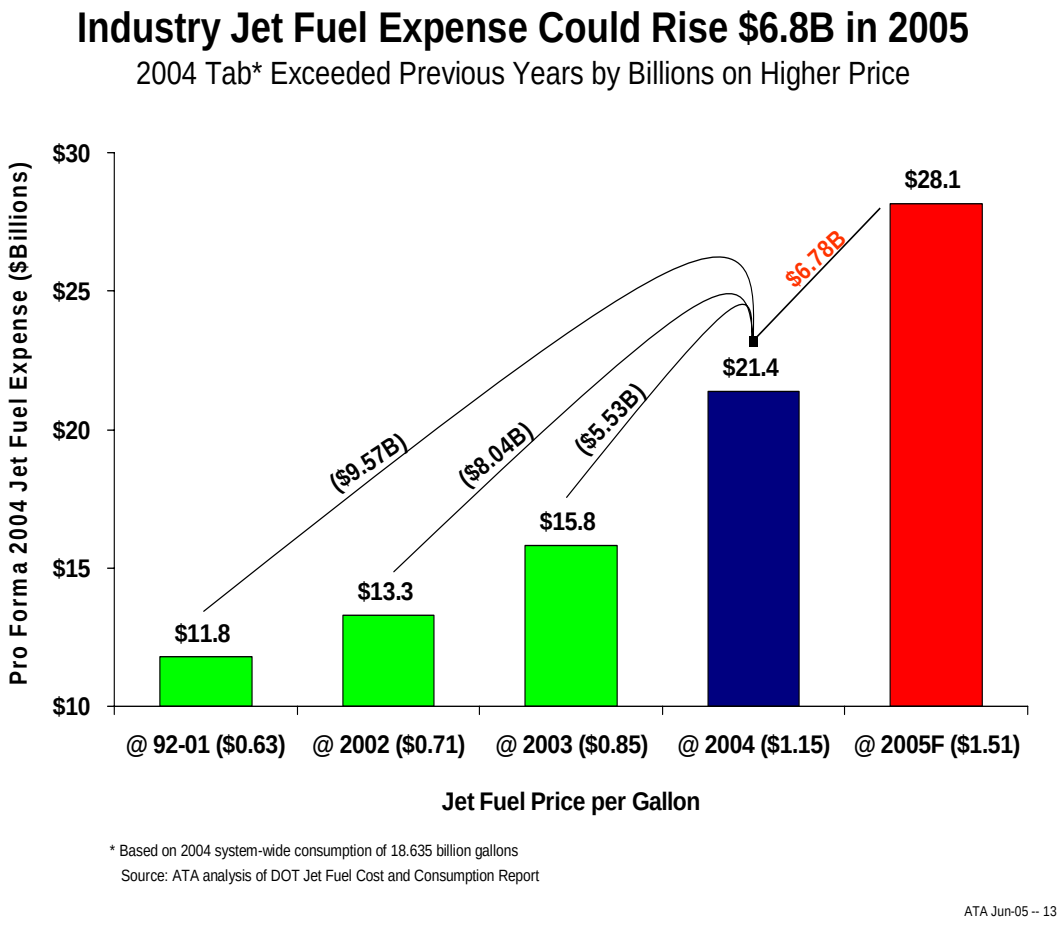


Jet Fuel prices have mirrored the price of crude oil, and 2005 prices are expected to surpass the 2004 record prices. The true cost impact on the airlines of this unprecedented increase is staggering and virtually defies comprehension. As the charts below show, the industry's 2004 jet fuel expense would have been $11.8 billion at the average price paid during the 1992-2001 period, compared to the actual $21.4 billion paid in 2004. We now expect the industry fuel bill to rise another $6.7 billion in 2005, to

more than $28 billion, assuming fuel consumption remains unchanged. At some airlines, fuel costs now exceed personnel costs as the number one expense category.[2]



[2] *Jet Fuel Expense Surges Past Personnel Costs*, MSNBC.com (July 11, 2005).



Given the vigorous competitive climate of the industry, discussed below, airlines have not been able to include in ticket prices the increased cost of fuel. To cover the jet fuel price increases from 2003 to 2004, for example, passengers would have had to pay on average an additional $21 per ticket. Yet ticket prices during this period fell because of intense competition. The industry would be in a much different, healthier condition had the airlines been able to pass on their actual fuel costs.

An operating fundamental of the industry is that airplanes run only on jet fuel. There is no alternative. The related economic fundamental is that the dramatic change in the price of fuel now appears to be permanent. The days of $20-$35 per barrel oil are over. We will be fortunate if the price slips back to $40-$50 per barrel. Given the

worldwide demand for oil products and finite refining capacity, particularly in the U.S., some analysts predict even higher prices. A recent Goldman Sachs report suggests prices may rise as high as $105 per barrel.[3] Moreover, the market is highly susceptible to any possible supply disruption, as the price spike in anticipation of tropical storm Arlene in early June illustrated.[4] On June 17th, oil surged to a then-all time high – exceeding $58 per barrel – over concerns about both supply and refining capacity.[5] Last week, oil prices eclipsed $60 per barrel, continuing an apparently inexorable climb upward.

The increase in the price of fuel has been rapid and dramatic. Because of the complexity of market forces at play in the airline industry, this fundamental economic change strongly affects the cost side of the ledger, increasing the revenues needed for profitability. As a result, complete recovery – defined by a return to profitability – remains foreclosed. When the industry might achieve profitability remains uncertain. As one market analyst observed recently:

> On a non-fuel basis, operating profitability…is as good as it was in the late 1990s. While these facts are exciting…, they may also be totally moot if oil prices do not return to [historical norms]…*Unfortunately, high fuel prices are consuming what would otherwise be an upcycle for the industry.*[6]

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[3] Goldman Sachs, *"U.S. Energy: Oil – Super Spike Period May be Upon Us,"* March 30, 2005.

[4] A June 10, 2005 report issued by the Energy Risk Management Group of Fimat, for example, stated: "The response to Arlene's approach shows with brutal clarity how sensitive the market is to any possible supply disruption. With the potential impact on production and transportation at least part of the rally was justified…The storm headlines surprised and prompted waves of short covering and possibly a moderate amount of fresh speculative buying, as well." http://research.fimat.com/dominoapps/fimatres.nsf/0B9A9C6DBB71AF2E8625701C004AA162/$FILE/tcc1_new.pdf.

[5] "Oil Prices Surge All-time High," MSNBC, June 17, 2005, at http://www.msnbc.msn.com/id/5612507

[6] Gary Chase, Lehman Brothers, "Industry Update," March 15, 2005.

2. Taxes and Fees Weigh Down the Industry

The industry continues to be weighed down by excessive taxes and fees imposed on airlines and their customers. The negative economic impact of these taxes and fees is a drag on the industry and hampers its ability to return to profitability. This is one area in which the government could help more by doing less. As one analyst has noted:

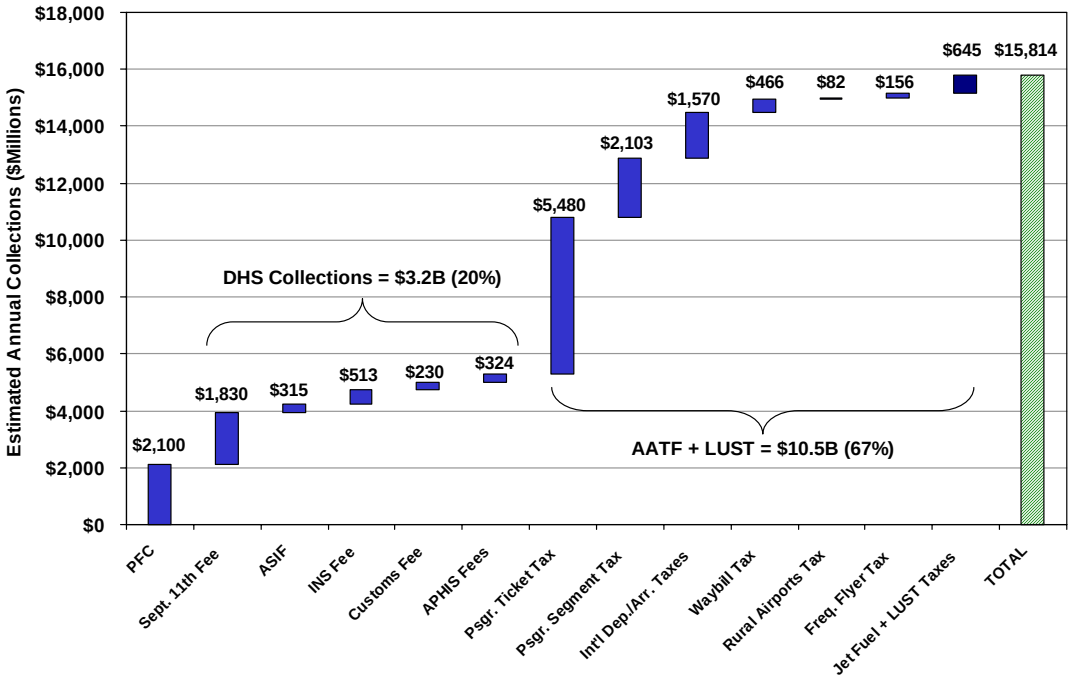
> [T]he airline industry pays the highest federal tax rate of any industry as it continues to lose massive amounts of money through user and security taxes that amount to an estimated 10% of revenues. …in reality, in a highly competitive, weak revenue environment, the taxes are paid for by the airlines...
>
> Ray Neidl, Speech at the National Air Service Conference (January 24, 2005).

The tax and fee burden on airlines operating in, to and from the U.S. exceeded $14 billion in FY2004 and are expected to exceed $15 billion in 2005. This tax burden distorts the normal functioning of market forces and fundamentally depresses the industry. Nonetheless, the appetite for taxing the industry remains strong. Since 1988, the average tax on a $200 domestic round-trip ticket has increased 250 percent, while average domestic yields have actually declined 3 percent. This is so despite the 1993 recommendation, made by the National Commission to Ensure a Strong Competitive Airline Industry, to relieve the industry of its "unfair tax burden."[7]

[7] "Tax policies often have had a major and adverse effect on the industry. Although the Commission concluded that tax changes alone will not restore the industry to profitability, we believe there are several tax provisions that impede the ability of the industry to return to financial health. We believe those provisions violate reasonable principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden." *Change, Challenge and Competition: A Report to the President and Congress* (August 1993), The National Commission to Ensure a Strong Competitive Airline Industry.

Special Aviation Taxes and Fees: Collections

$15.8 Billion in Aviation Excise Tax Collections Estimated for 2005*



*Some taxes and fees shown include collections from non-U.S. carriers

Sources: ATA; Federal Aviation Administration; U.S. Department of Homeland Security; U.S. Office of Management and Budget

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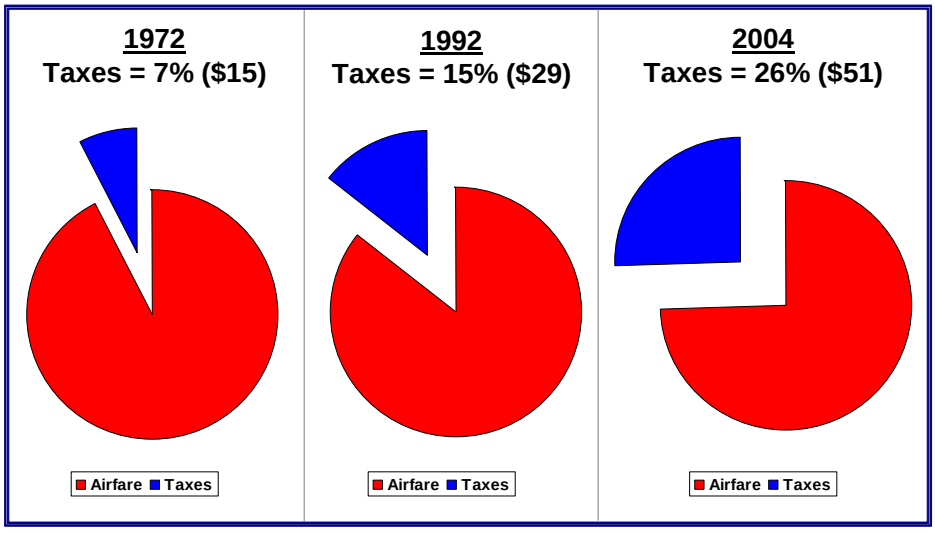
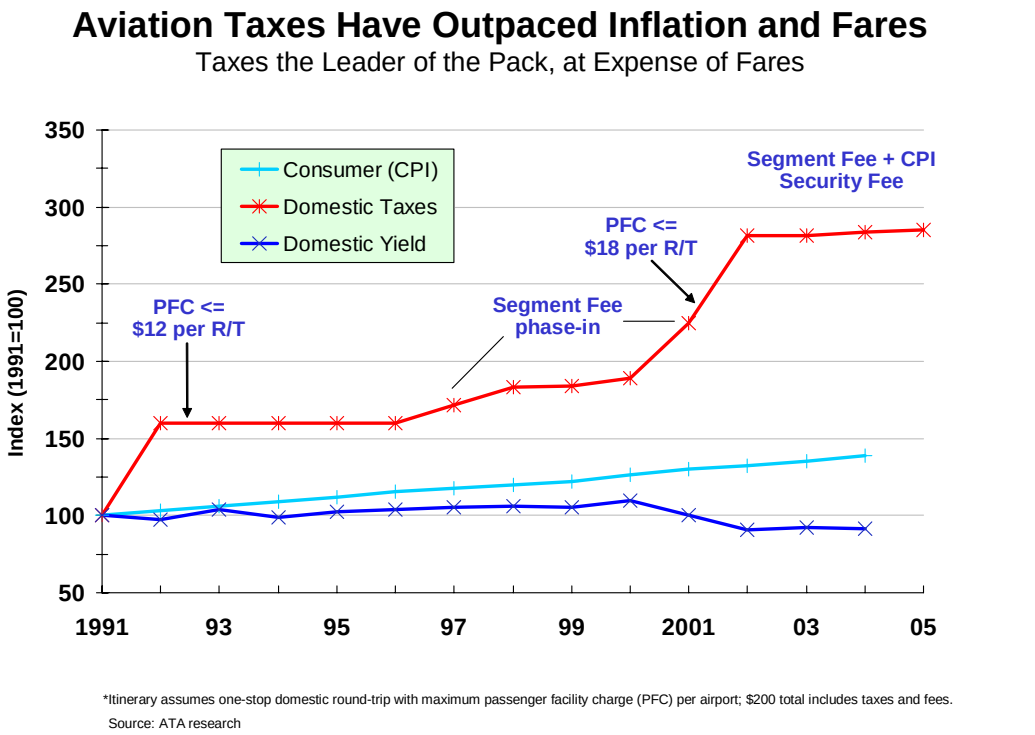
Uncle Sam Taking a Bigger Bite

Once a Small Fraction, Federal Taxes/Fees Now a Fourth of Sample Ticket*



* Itinerary assumes a single-connection domestic roundtrip with maximum passenger facility charge (PFC) at each airport; $200 total price includes taxes and fees.

Aviation taxes have outpaced inflation and prices, and air transportation is taxed at a higher rate than the consumption of beer and liquor, telephone service, and most notably, bus and rail transportation, which face no federal travel tax.



Federal Consumption Taxes & Fees High on Flyers*

Uncle Sam Taxes Low-Priced Air Travel Above Sins, Luxuries, and Other Modes

Product	%	Product	%
Plane Ticket: One-Stop ($100)[1]	44.2	Heavy Firearms / Ammunition	11.0
Plane Ticket: Non-Stop ($100)[1]	25.6	Distilled Spirits ($20)[4]	10.7
Plane Ticket: One-Stop ($200)[1]	25.6	Sport Fishing Equipment	10.0
Plane Ticket: One-Stop ($300)[1]	19.4	Pistol or Revolver	10.0
Pack of Cigarettes ($4.50)[2]	18.2	Can of Beer ($1.00)[5]	5.0
Plane Ticket: Non-Stop ($200)[1]	16.3	Luxury Vehicle (Portion > $40K)	3.0
Plane Ticket: Non-Stop ($300)[1]	13.2	Telephone Service	3.0
Arrow Components	12.4	Elec. Outboard Motors / Sonar[6]	3.0
Heavy Truck / Trailer / Tractor	12.0	Ship Ticket ($1,000)[7]	0.3
Gallon of Gasoline ($1.60)[3]	11.5	Bus Ticket	0.0
Bows	11.0	Rail Ticket	0.0

[1] Roundtrip with federally approved $4.50 PFC
[2] Taxed at 82¢ per pack
[3] Taxed at 18.4¢ per gallon
[4] Taxed at $2.14 per 750-milliliter bottle
[5] Taxed at 5¢ per can
[6] Up to a maximum of $30.00
[7] Taxed at $3.00 per ticket

Note: The federal government also taxes the sale of tires over 40 pounds, coal, wine, vaccines, foreign-issued insurance, and selected other items.

*Analysis considers federal taxes and fees only; does not examine the broader impact of state and local taxes, which can be especially high on alcohol and tobacco.

Sources: ATA research; Internal Revenue Service; Bureau of Alcohol, Tobacco & Firearms

ATA appreciates this Committee's efforts to upend the administration's proposed increase of the passenger security fee for FY 2006. As this Committee is well aware, security fees and taxes account for a significant portion of the overall tax and fee burden on the industry. In FY 2005, we estimate that the industry will provide to DHS over $3.2 billion in direct fees and taxes. Add to this the foregone revenue from certain federally mandated programs and the out-of-pocket expenses for other unfunded mandates, and very quickly the industry's annual security cost burden exceeds $4 billion. That number will only increase as more passengers fly. Yet the administration and members of Congress continue to discuss and debate several new mandates.[8] The airline industry

[8] These include, but are not limited to, installation and maintenance of counter-manpads devices, additional in-line EDS baggage screening equipment, increased cargo screening on passenger and all-cargo flights, implementation of the DHS Secure Flight passenger screening program, and promulgation of a rule requiring airlines to transmit passenger manifest and related passport data one hour before departure of in-bound international flights.

cannot be expected to achieve profitability if the government continues to impose more and more taxes, fees and unfunded mandates.

Unfortunately, the "cash cow" view of the airline industry infects the rest of the world. Several G-8 member states recently proposed a "solidarity tax" on airplane tickets as a mechanism to raise money to assist developing countries address health and welfare needs. In the view of these countries, because the airline industry facilitates globalization, and because "airline passengers seldom belong to the poorest segments of the population," a tax on air transportation is justified. The problem with this approach, of course, is that it is basically an "ends justify the means" argument and could apply to any number of issues regardless of merit.

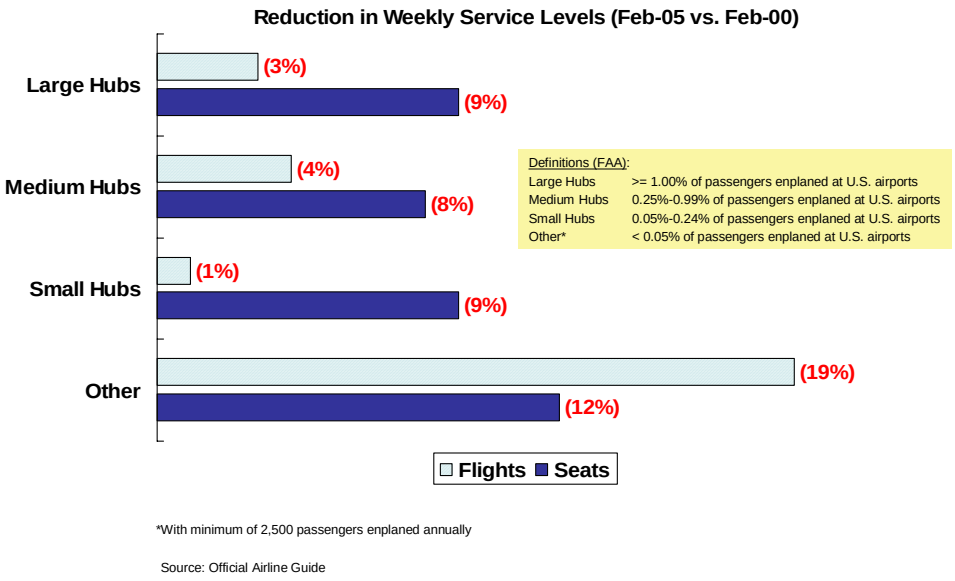
As we have said previously, it does not matter whether a tax or fee is imposed on passengers or airlines. It is the imposition of the tax that is significant,[9] with the result being that the more the government collects for air travel, the less the airlines are able to charge. As Treasury Secretary Snow has stated, "Economics tells us that anything you tax, you get less of. That's why high marginal taxes…are a bad idea – they kill jobs." In our view, with the right tax policy, the government can foster job creation and financial stability in the industry.

Unfortunately, excessive taxes on the airline industry are crippling a vital segment of our economy. The U.S. airline industry plays a major role in driving the commerce of the United States and the growth of our national economy. An economically crippled

[9] "The statutory incidence of a tax indicates who is legally responsible for the tax…Because prices may change in response to the tax, knowledge of statutory incidence tells us essentially nothing about who is really paying the tax…***The [economic] incidence of a unit tax is independent of whether it is levied on consumers or producers***…In general, the more elastic the demand curve, the less the tax borne by consumers…The key point to remember is that nothing about the incidence of a tax can be know without information on the relevant behavioral elasticities." *Public Finance (4th Ed.),* Harvey S. Rosen (Princeton University Department of Economics)

airline industry is a drag on the national economy and ultimately will prevent it from realizing its full potential. Robust air transportation is critical to sustaining our recovery and catalyzing the next round of growth essential to our nation's economic competitiveness. As airline job losses continue to mount, and service to small- and mid-size communities is cut, it is not simply the airlines and their employees who are suffering; it is the broader economy that feels the results. Air transportation grows both the national and local economies – its absence reverses that effect.

Small-Community Service Down Sharply Post-9/11



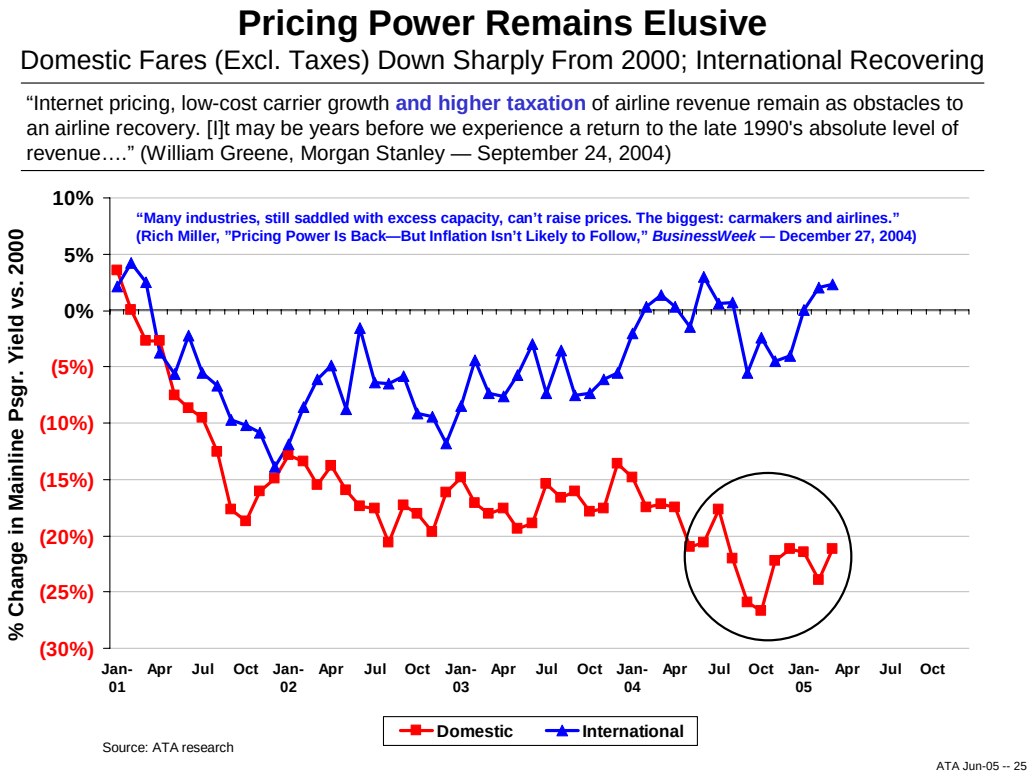
3. Pricing Power Remains Inadequate for Airlines to Recover Costs

Throughout 2004 and well into 2005, U.S. airlines were unable to raise prices. Numerous efforts failed because of the intense competitive nature of the industry and the fundamentals of supply and demand. Market analysts uniformly observed that ***all*** airlines lacked pricing power to pass through increased costs. For example:

> [L]egacy carriers and LCCs continue to fight strenuously for market share with a complete lack of pricing power creating an anemic revenue environment…Fuel …remains a major factor in the industry's inability to make a profit and we remind investors that this is not the first time the airlines have been faced with tough year over year comps. However, this is the first time that carriers have not been able to pass these costs on to the consumer as evident by several failed fare increases and the declining yields.

Reno Bianchi and Steven K. Burton, Citigroup Corporate Bond Research, Airline Industry Research Report, December 21, 2004.

The following chart illustrates the lack of pricing power from January 2001 through the first quarter of 2005 by tracking mainline passenger yields:



Recently, airlines have been able to maintain some price increases, and this modest success offers a glimmer of hope for the future. At this point, however, it remains only a glimmer. During the second week of June, for example, multiple attempts

at fare increases failed under competitive pressures.[10] Passengers remain extremely price sensitive, and price competition among all airlines is robust.[11] Consequently, even low cost airlines are not sanguine about increasing revenue through fare hikes, as confirmed by Independence Air's Eric Nordling: "The flying public is highly elastic; it is very sensitive to price."[12]

The simple truth is that if the airlines could raise their prices to cover fuel costs and the many taxes and fees they pay, they would have done so by now. They haven't, and basic marketplace principles – competition and elasticity – are continuing to prevent them from doing so. It remains to be seen when, if ever, pricing power returns to the point where profitability can be restored notwithstanding increasing fuel prices.

4. Expanding the Air Traffic Control System's Capacity and Enhancing ATC Productivity is Critical to the Financial Health of the Industry

The American people want convenience and value for their money. That is why they are flying in record numbers this summer. U.S. airlines provide safe, convenient and reliable service at a fair price.[13] Maintaining system reliability, however, is becoming increasingly difficult as airlines, responding to marketplace demands for service, add flights. The financial health of the industry – today and in the future – depends in part on the ability of the FAA's Air Traffic Control (ATC) system to provide the capacity needed

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[10] "Airfare Momentum Stalls After Successive Price Hikes," *Business Travel News*, June 7, 2005; "Airline Profits Are So Close, Yet Still So Far," *New York Times*, June 12, 2005; Northwest Pulls Fare Increase," *Aviation Daily*, June 14, 2005.

[11] "[Several airlines] raised fares on some routes, then cut them a day or two later when bookings fell..." "Even if they wanted to take advantage of the heavy demand for summer travel, the big airlines do not have carte blanche to raise fares, because low-fare airlines keep them from doing so." *New York Times*, June 12, 2005.

[12] *Id.*

[13] Adjusted for inflation, domestic airfares, net of taxes, have dropped 51 percent over the past 25 years.

to meet not only the demand for scheduled passenger and cargo operations, but also the growing appetite of the non-scheduled sector, including air taxis, business jet operations and, in the near future, Very Light Jets. [14]

Inadequate ATC system capacity will stymie airline growth and the ability of the industry to achieve and maintain financial health. That, in turn, will adversely affect the commerce of the United States and the American public. Without a dramatic change in the way our nation's airspace is managed, congestion and resulting delays will be overwhelming for consumers and businesses alike. As it is, 86.5 million ATC delay minutes were responsible for adding an estimated $6.2 billion to direct operating costs for U.S. airlines in 2004. The FAA is predicting that by the end of 2005 commercial aviation flights will have regained the peak levels of 2000. [15] Operations at en route centers actually have surpassed the number handled in 2000.[16]

Just maintaining the safety and efficiency of our air traffic system at the current level of operations is not an option. The FAA will have to increase system capacity and productivity to accommodate an estimated 25 percent increase in the volume of air traffic in the next decade.[17] In fact, the Joint Planning and Development Office is seeking to

[14] *Year One – Taking Flight: 2004 Annual Performance Report*, Federal Aviation Administration, Air Traffic Organization (March 2005) (the "ATO 2004 Annual Report"), p. 23.

[15] ATO 2004 Annual Report, p.23.

[16] *Next Steps for the Air Traffic Organization*, Statement of the Honorable Kenneth M. Mead Before the Committee on Transportation and Infrastructure, Subcommittee on Aviation, United States House of Representatives (April 14, 2005) p. 2 ("Mead Testimony"), . p.2.

[17] Federal Aviation Administration, *Aerospace Forecasts, Fiscal Years 2005-2016*, Table 36, X-37.

expand capacity by as much as 300% by 2015 to accommodate changes in aircraft size as well as the projected growth in demand.[18] ATA members support these efforts.

The alternative, measures that restrict operations such as those imposed at Chicago's O'Hare International Airport, are unacceptable. Arbitrary restrictions on operations will undermine the public benefits Congress envisioned when it deregulated the industry. Ultimately, such restrictions will add new operating costs as access to the system is rationed. Indeed, within the administration, the notion of "market-based" solutions to allocate landing and take-off rights at certain airports is gaining currency already. These solutions could result in new fees and charges that airlines would have to pay. Realistically, given the fierce price competition within the industry, it is unlikely these new charges could be passed on to customers.

The solution lies in a modernized ATC system that uses technology and operational measures to increase capacity and enable growth. In the near term, consolidating facilities and decommissioning outdated equipment and procedures should provide help at the margins. Capacity of the current system can be increased by leveraging existing on-board technologies and creating new satellite-based routes that are more flexible than existing routes; gains can also be achieved by doing a better job keeping slower airplanes separated from faster moving airplanes. A key measure is to manage the ATC system from a national perspective instead of the current patchwork of airspace components, each managed individually. This locally-driven system creates too many opportunities for bottlenecks and inefficient use of the airspace from a total system

[18] Joint Planning and Development Office, Next Generation Air Transportation System Integrated Plan (December 2004), p. 8.

perspective. Looking forward, any new system must be built on a scalable architecture that maximizes flexibility and ease of growth.

Conclusion

The U.S. airline industry remains in dire financial condition, with several airlines in Chapter 11 and other airlines facing that possibility as oil prices continue to climb. The prospects for a return to stability and profitability remain uncertain in light of factors largely out of the control of the airlines. Nevertheless, it can be said that a glimmer of hope is on the horizon. People are flying again in record numbers, and airline cost-cutting measures are having a positive impact.

Looking forward, Congress and the administration will play a significant role in the financial health of the industry. The tax and fee burden remains excessive and should be reduced. By no means should new taxes and fees be added, no matter what the purpose. Further, when the Aviation Trust Fund comes up for reauthorization in 2007, it will be imperative that Congress support the FAA's efforts to expand ATC system capacity to permit expected industry growth. At that time, Congress should adopt a new funding formula that fairly apportions trust fund contributions among system users according to their use of the ATC system.